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SIPDIS

TREASURY FOR INT'L AFFAIRS - CPLANTIER AND MNUGENT
NSC FOR MCKIBBEN

SENSITIVE

E.O. 12958: N/A
TAGS: EFIN TU
SUBJECT: SHARP SELL-OFF IN TURKISH MARKETS

THIS CABLE HAS BEEN COORDINATED WITH CONGEN ISTANBUL.

1.(SBU) Summary: A decline in Turkey's financial markets turned into a rout Friday, May 12 and continued May 15. Driven by a combination of global and local factors, investors -- especially foreign investors -- reached a tipping point and reduced their Turkish positions. Neither the Government nor the Central Bank has any easy tools with which to stop the slide, but at this stage a 2001-style crisis seems only a remote possibility. End Summary.

Market Decline Turns into a Rout

¶2. (U) During the first four months of 2006, Turkish financial markets continued to go their bullish way, with equities continuing to rise as the lira accompanied the dollar's gradual fall against the euro. In May, however, sentiment cooled due for a variety of global and local reasons. On Friday, May 12, the gradual decline turned into a rout given increasingly unfavorable global market conditions and more and more market-unfriendly local and regional news flow. Though there was no single event that triggered the sell-off, a series of concerns finally reached a tipping point.

¶3. (U) On Friday, the IMKB 100 stock market index fell 3.99%, the exchange rate dropped 4.5% against a Euro-dollar basket and the yield on the benchmark bond rose to 14.51%, the highest rate so far in 2006. For the week the IMKB was off 6.13%, the exchange rate had fallen 6.6% and the yield rose from 14.13% to 14.51%. The lira closed at 1.3976 to the dollar -- an eighteen month low -- and 1.8032 to the euro. New Central Bank Governor Durmus Yilmaz, attempted Friday to reassure markets by reaffirming the Bank'scommitted to the floating exchange rate regime. He also said the higher-than-expected April inflation numbers had not altered the Bank's medium-term inflation projections. The Governor said the Bank was watching market developments closely. This statement was sufficient to cause markets to pause in their fall and even pull back a bit.

¶4. (U) On Monday, however, following an overnight sell-off in Asian markets, the free fall continued with the IMKB 100 down an additional 3.45% to 40,519.89 at 2:35 local time, the exchange rate down to 1.46 to the dollar and 1.86 to the Euro. The benchmark yield rose to 14.82%.

Causes Local and Global

¶5. (U) First among the global factors were signs of the long-expected weakness in Emerging Markets as a result of tightening monetary policy in the U.S., Europe and Japan. This tightness particularly affects Turkey, since many international investors in Turkish markets do so by means of "carry trades," i.e. borrowing in low-interest currencies like the yen and investing in high-yielding Turkish assets. An HSBC trader told May 13 that investors were not renewing the normally-popular yen-lira carry trades.

¶6. (SBU) Over the previous days and weeks, a variety of local and regional factors combined to make market participants increasingly anxious. Among the longstanding worries were high oil prices that exacerbate Turkey's widening current account deficit; concerns about regional tension (especially vis-a-vis Iran); and increasingly acrimonious domestic political wrangling with more and more talk of early elections. Early elections are considered a negative for markets since they bring with them the possibility that the market-unfriendly Nationalist Party (MHP) would enter parliament and possibly even form a coalition government with the AK Party.

¶7. (SBU) On more purely economic issues, markets were surprised by unexpectedly high April inflation numbers, which wrong footed the Central Bank: Only days beforehand the Monetary Policy Committee, chaired for the first time by newly-appointed Governor Yilmaz, cut rates a quarter point. With the prospect of the Bank facing greater-than-foreseen difficulties getting close to the 5% year-end target, inflation expectations and interest rates blipped upwards.

¶8. (SBU) President Sezer's May 10 veto of Social Security Reform legislation further rattled markets. Although the President's veto is likely to be overridden by parliament, it created new uncertainties that the reform would not be implemented in a way as to bring the social security system's red ink under control. The reform is also crucial for the IMF program.

Uncertain Outlook

¶9. (SBU) Some observers welcome a limited market slide as a healthy corrective to what they see as excessive investor enthusiasm. They also believe a weaker lira will give exporters a competitiveness boost, particularly for exports to Europe. On the other hand, if the downturn marks the beginning of a sustained fall in Turkish markets, neither the government nor the Central Bank have easy access to tools that can stop the slide.

¶10. (SBU) Though the Central Bank could intervene to support the lira, this would run counter to the Bank's longstanding claims that its interventions are primarily intended to build up foreign exchange reserves. The Bank had long warned investors it would not facilitate their exit from the market (i.e. buy lira in a correction). The Bank could, however, raise interest rates, which could send a signal of renewed inflation-fighting zeal and would help Turkish yields become attractive again.

¶11. (SBU) Quickly wrapping-up an agreement with the visiting IMF mission on a new Letter of Intent without the customary drama could also give markets a shot in the arm. The more the Government can do in the way of strong fiscal and structural measures in this IMF review to show a renewed commitment to the reform track the more it is likely to help markets. Likewise, the sooner parliament overrides Sezer's veto of the social security legislation the better.

Crisis Unlikely

¶12. (SBU) The sharp fall with seemingly no buyers of lira assets is the worst correction since at least the spring of 2004. Though worrisome, it has some way to go before it gets into crisis territory. Even if it does, Turkey's much-improved fundamentals, including a strengthened fiscal situation a better-capitalized banking sector and improved public sector debt ratios suggest the likelihood of a full-blown financial crisis a la 2001 is remote.

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